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ORIGINAL

BEFORE THE INSURANCE COMMISSIONER

OF THE STATE OF CALIFORNIA

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ADMINISTRATIVE HEARING BUREAU

In the Matter of the Rate Application of	)
	) FILE NO.:PA-2007-00004
	)
ALLSTATE INSURANCE COMPANY and ALLSTATE INDEMNITY COMPANY,	)
	)
Applicants.	)
	)

FINAL RULINGS AND ORDER ON MOTIONS BY THE CALIFORNIA DEPARTMENT OF INSURANCE AND BY THE FOUNDATION FOR TAXPAYER AND CONSUMER RIGHTS TO STRIKE PORTIONS OF ALLSTATE'S SUPPLEMENTAL TESTIMONY AND ON ISSUE OF *PRIMA FACIE* PROOF OF CONFISCATION

On August 31, 2007, the California Department of Insurance ("CDI") and Intervenor, Foundation for Taxpayer and Consumer Rights ("FTCR"), filed motions to strike portions of the supplemental testimony of Steven D. Armstrong and Robin Haworth, filed on August 24, 2007, by Allstate Insurance Company and Allstate Indemnity Company ("Allstate"). Allstate filed an omnibus response to the motions on September 10, 2007. A tentative ruling on the motions to strike was faxed and mailed to all parties on September 14, 2007.

The motions to strike and determination of the issue whether Allstate had presented *prima facie* proof of confiscation came on for hearing on September 17, 2007,

Administrative Law Judge Christopher R. Inama ("ALJ") presiding. Present at the hearing were Neal L. Wolf, Esq., Kathryn H. Baxter, Esq., Brett J. Kitei, Esq., Tod Padnos, Esq., and Kathleen Sullivan, Esq., of the LeBoeuf, Lamb, Green, & MacRae Law Firm, and Charles M. Smith, in-house counsel, for Allstate; Don Hilla, Esq., and Daniel Goodell, Esq., for CDI; and Daniel Zohar, Esq., Todd M. Foreman, Esq., and Pamela Pressley, Esq., for FTCR. Having considered the motions and Allstate's opposition thereto, and the further arguments of counsel at the hearing, the motions are granted, as set forth below.

Procedural Background.

On August 3, 2007, a hearing was held on motions by CDI and FTCR to strike portions of the initial round of direct written testimony by Allstate's witnesses, and it was determined that Allstate had not then made a *prima facie* showing in support of its Variance Request No. 11 (based on an alleged confiscatory rate). Therefore, portions of the testimony by certain of Allstate's witnesses were potentially irrelevant and were only conditionally admitted, pending further proof by Allstate.

By order of August 7, 2007, Allstate was granted extraordinary leave to file supplemental testimony in support of its Variance Request No. 11. If Allstate did not establish a *prima facie* case of confiscation by that supplemental testimony, then the conditionally admitted portions of testimony by Steven D. Armstrong, J. David. Cummins, and Michael J. Miller, would be irrelevant and would be stricken on renewed motions by CDI and FTCR. (See Order on Motions to Strike, August 7, 2007, p. 10) Pursuant to that order, Allstate filed supplemental testimony by Steven D. Armstrong and

Robin Haworth, and CDI and FTCR moved to strike that supplemental testimony and renewed their motions to strike conditionally admitted testimony.

The issue is whether Allstate has made a *prima facie* showing that the regulatory rate, as applied in this case, is confiscatory. (Cal. Code of Regs, tit. 10, §§2644.2 and 2644.27, subd. (f)(11).) If Allstate has not made that *prima facie* showing, then Allstate's testimony and exhibits relating to the Fama-French 3 Factors model ("FF3F")[1] and other formulae with which Allstate wants to replace components of the regulatory formula are irrelevant. If the testimony and evidence are irrelevant, then they will be out of order, will entail undue consumption of time, and must be stricken. (Cal. Code of Regs, tit. 10, §§2646.4, subd. (c) and 2654.1, subd, (c).).

Contentions on Motions by CDI and FTCR to Strike Supplemental Testimony of Steven D. Armstrong and Robin Haworth.

CDI moves to strike the entire supplemental testimony of Mr. Armstrong and Mr. Haworth, and FTCR moves to strike specific portions of their supplemental testimony, on the grounds that portions of the testimony (1) are irrelevant and impermissible relitigation of the Commissioner's regulations; and (2) offer inappropriate legal conclusions.

Specifically, the CDI and FTCR contend that portions of the Allstate witnesses' testimony purport to relitigate matters already determined by the rate-setting regulations and by generic determinations therein, in violation of California Code of Regulations, title 10, section 2646.4, subdivision (c).[2] CDI and FTCR also contend that Allstate's

[1] FF3F is a multiple regression econometric model, embraced by many academics, for projecting a rate of return for investors. Thus, it has a different purpose than the rate of return set out in the regulations and appears to produce a significantly higher rate of return than the regulatory rate. (See Cal. Code of Reg., tit. 10, §2644.16.)

[2] Section 2646.4, subdivision (c) provides: "Relitigation in a hearing on an individual insurer's rates of a matter already determined either by these regulations or by a generic determination is out of order and shall not be permitted. However, the administrative law judge shall admit evidence he or she finds relevant to the determination of whether the rate is excessive or inadequate (or, in the case of a proceeding under Article 5,

Variance Request No. 11 cannot be interpreted so broadly as to permit relitigation of the components of the rate-setting formula. CDI and FTCR further contend that the Allstate witnesses purport to state inappropriate legal conclusions.

CDI and FTCR also assert that Allstate has not made a *prima facie* showing that the regulatory rate, as applied to Allstate in this case, is confiscatory. Therefore, portions of Allstate's testimony, previously admitted conditionally, should be stricken. CDI points out that Allstate tries to demonstrate confiscation by replacing the regulatory formula with its own theories and methodologies, including replacement of the regulatory formula's rate-of-return component with Allstate's own econometric model. CDI also argues that Allstate misstates the law regarding the treatment of expenses. Likewise, FTCR contends that Allstate's approach of piece-meal re-evaluation of the components of the regulatory formula is relitigation and irrelevant to the determination of the confiscation issue.

Allstate counters that all relevant evidence is admissible (Ins. Code §1861.08; Govt. Code §11513), and it is not attempting to relitigate the Commissioner's regulations and generic determinations, but is only attempting to demonstrate that the rate calculated without the constitutional variance is confiscatory as a matter of law. Allstate contends that its supplemental testimony is within the permissible scope of opinion testimony.

With respect to the confiscation issue, Allstate argues that: (1) CDI's theory of confiscation is wrong; (2) that Allstate has satisfied FTCR's theory of confiscation; and

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relevant to the determination of the minimum nonconfiscatory rate), whether or not such evidence is expressly contemplated by these regulations, *provided the evidence is not offered for the purpose of relitigating a matter already determined by these regulations or by a generic determination.*" (emphasis added)

(3) Allstate's consistent articulation of the confiscation standard follows Supreme Court precedent.

DISCUSSION

Objections Based on the Bar Against Relitigation of the Commissioner's Regulations and Generic Determinations.

Both CDI and FTCR contend that the bar against relitigating the Commissioner's regulations and generic determinations requires that testimony challenging components of the rate-setting formula be stricken. Allstate contends the bar is not complete, and Allstate should be permitted to present evidence relevant to determining the lowest non-confiscatory rate.

California Code of Regulations, title 10, section 2641.1 states, "This subchapter is adopted to implement the provisions of Proposition 103, governing approval of insurance rates." The regulations are clear: "While companies remain free to formulate their rates under any methodology, the commissioner's review of those rates must use a single, consistent methodology." (Cal. Code of Regs., tit. 10, §2643.1.) The methodology the commissioner is to apply is set forth in a formula described in California Code of Regulations, title 10, section 2644.1, *et seq*. Nevertheless, Allstate asserts that its actuaries and economists may calculate its rates using different theories and methodologies. Thus, according to Allstate, the regulatory formula is incomplete or wrong and should not serve as the standard of review for its rate application and variance requests.

California Code of Regulations, title 10, section 2646.4, subdivision (e), bans relitigation of the regulations implementing Proposition 103. In *20th Century Ins. Co.* v.

Garamendi (1994) 8 Cal.4th 216, 312, the California Supreme Court clearly upheld this relitigation ban:

> The effect of the "relitigation bar" is unobjectionable. In adjudication, the judge applies declared law; he does not entertain the question whether its underlying premises are sound. That is as it should be. Otherwise, standardless, *ad hoc* decision making would result. Similarly, in quasi-adjudicatory proceedings, the administrative law judge applies adopted regulations; he does not entertain the question whether their underlying premises are sound. That is also as it should be, and for the same reason.

To the extent that Allstate's witnesses challenge the ALJ's use of the regulatory formula as the method of review in this hearing, it is impermissible relitigation. For example, in his supplemental testimony, Steven D. Armstrong states that Allstate does not seek to "change" the rate-making formula; then, he testifies that dramatic substitutions for components of the rate-making should be made:

(1) FF3F should replace the regulatory formula's "rate of return" component. (3:11-22; see Cal. Code of Regs, tit. 10, §2644.16.)

(2) Allstate's own internally developed leverage factor model should replace the regulatory formula's leverage factor component. (3:23-28; see Cal. Code of Regs, tit. 10, §2644.17.)

(3) Allstate should use its own premium trend, instead of the one provided for in the regulatory formula. (5:14-6:7; see Cal. Code of Regs, tit. 10, §2644.7.)

Similarly, in his supplemental testimony, Robin A. Haworth attempts to relitigate the regulatory formula, testifying that Allstate's own calculations should be substituted for the regulatory formula. For example:

(1) FF3F should replace the regulatory formula's "rate of return" component. (2:20-3:2; see Cal. Code of Regs, tit. 10, §2644.16.)

(2) The regulatory use of "surplus" and Statutory Accounting Principles ("SAP") should be replaced by "book value" or "market value" and "Generally Accepted Accounting Principles ("GAAP"). (3:3-6:12; see Cal. Code of Regs, tit. 10, §§2643.5 and 2644.17; *20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at pp. 301-302.)

(3) Allstate's own internally developed leverage factor model should replace the regulatory formula's "leverage factor" component. (6:13-6:24; see Cal. Code of Regs, tit. 10, §2644.17.)

(4) The question of "confiscation" should be determined line-by-line, contrary to the regulations and judicial authority, which require an end-result test, applied to the enterprise as a whole. (7:1-14:15; see Cal. Code of Regs, tit. 10, §2644.27, subd. (11); *20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at pp. 308-309.)[3]

In spite of Allstate's protestations, most of the testimony of Mr. Armstrong and essentially all of the testimony of Mr. Haworth is transparently "offered for the purpose of relitigating a matter already determined by these regulations or by a generic determination," in violation of the relitigation bar in California Code of Regulations, title 10, section 2646.4, subdivision (c). (*20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at p. 312.) Therefore, that testimony must be stricken.

Objections Based on "Legal Conclusion."

Portions of Allstate's supplemental testimony combine the witnesses' opinions of what the standard of review in this matter should be with their understanding of the

[3] This is a proceeding for the determination of relevance and, therefore, admissibility of certain of Allstate's proffered testimony. Consequently, even though Allstate devotes four full pages in its omnibus opposition to these motions to the question whether CDI or FTCR has defined Allstate's "enterprise" correctly for the purpose of applying the "end-result test" for confiscation, that issue need not be determined in this proceeding. (see Cal. Code of Reg., tit. 10, §2644.27, subd. (f)(11); see *20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at pp. 258, 293, 296, 308-309.)

requirements laid out in California Code of Regulations, title 10, §2644.1, *et seq.*, and their conclusions as to whether Allstate may use non-regulatory formula calculations. In these instances, as described above, the witnesses provide calculations that are not based upon the regulations.

Evidence Code §801 requires that any opinion elicited from a witness testifying as an expert be about a subject that the trier of fact needs assistance in understanding and that the opinion be based on matters personally known to the witness and reasonably relied upon by experts forming opinions on the subject of the testimony. Pursuant to Evidence Code §802, an expert witness may state on direct examination the reasons for his or her opinion and the matter upon which it is based unless precluded by law from using such matters as the basis of his or her opinion. Testimony in the form of an opinion that is otherwise admissible is not objectionable under Evidence Code §805 because it embraces the ultimate issue to be decided by the trier of fact.

Case law distinguishes between expert opinion on ultimate non-legal issues and expert opinion on questions of law. An expert's help is not needed to aid a judge in interpreting a statue, or, by a parity of reasoning, a regulation. (*Jones v. Superior Court* (1986) 188 Cal.App.3d 634 [declaration of school board members concerning the meaning of a local regulation is irrelevant and, as expert testimony, inadmissible]; *Downer v. Bramet* (1984) 152 Cal.App.3d 837 [rule that opinion evidence which is otherwise admissible is not made inadmissible simply because it embraces an ultimate issue does not authorize expert to testify to legal conclusions in the guise of expert testimony].)

The ALJ is capable of overlooking legal opinion testimony, and the administrative forum provides for less rigid adherence to evidentiary rules. To clarify the evidentiary record, however, testimony by Mr. Armstrong and Mr. Haworth, in which they interpret the law or opine on what standard of review should be used in this matter, and purport to conclude that Allstate is in conformance with or is excused from conforming to the regulations, will be stricken.

Allstate has not Made a *Prima Facie* Showing that the Regulatory Formula's Rate, as Applied to Allstate in this Case, is Confiscatory.

Along with its insurance rate application, Allstate filed Variance Request No. 11, on the ground that the maximum permitted earned premium under the regulatory formula would be "confiscatory," as applied to Allstate. (Cal. Code of Regs, tit. 10, §§2644.2 and 2644.27, subd. (f)(11).) Allstate has the burden of proving every fact necessary to demonstrate that the regulatory formula's rate is confiscatory. (Cal. Code of Regs, tit. 10, §2646.54; *20th Century Ins. Co.* v. *Garamendi*, supra, 8 Cal.4th at p. 292 ["'The burden of proving' otherwise 'rests on the party asserting the violation'.... It 'is not easily met....'"].) Irrelevant evidence is inadmissible (Evid. Code §§210, 350; Govt. Code §11513, subd. (c)), and the ALJ has discretion to exclude evidence if its probative value is outweighed by the probability that its admission will necessitate undue consumption of time. (Govt. Code §11513, subd. (f); Cal. Code of Regs, tit. 10, §2654.1, subd. (c); see Evid. Code §350.) Further, Allstate may not offer evidence for the purpose of relitigating a matter already determined by the regulations. (Cal. Code of Regs, tit. 10, §§2644. subd. (c).)

Allstate now has had two opportunities to present a *prima facie* case that the regulatory formula's rate is confiscatory. At the previous hearing on CDI's and FTCR's

motions to strike portions of the initial round of direct testimony filed by Allstate, it became apparent that Allstate had not adduced relevant evidence in support of its Variance Request No. 11. At that hearing, both CDI and FTCR suggested that Allstate should have an opportunity to make its record on the issue. (Reporter's Transcript, August 3, 2007, 16:8-12, 20:24-21:5.) Although not specifically provided for in the regulations governing prior approval proceedings, by order dated August 7, 2007, Allstate was granted an extraordinary opportunity to make a *prima facie* showing in support of its Variance Request No. 11, conforming to the guidelines set out in *20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at p. 293-294.

With its initial filing of written testimony and the supplemental testimony filed under the grant of extraordinary leave to fill the gap in its proof of confiscation, Allstate has completed the introduction of its direct testimony on this issue. In administrative proceedings for the determination of rates, direct testimony must be given in writing and may not be delivered orally. (Cal. Code of Regs., tit. 10, §2646.1, subd. (a).)[4] Therefore, Allstate does not have another opportunity to present direct evidence that the regulatory formula's rate, as applied to Allstate, is confiscatory. Even if none of its testimony were stricken, and even though Allstate's direct testimony remains unrebutted, Allstate still has not made a *prima facie* showing that the regulatory formula's rate, as applied to Allstate, is confiscatory. Therefore, all of Allstate's evidence relating to a potential remedy for

[4] At the evidentiary hearing, the person whose prepared testimony is being offered shall be available for cross-examination by all parties. (Cal. Code of Regs., tit. 10, §2655.6, subd. (d).) Prior to cross-examination, the witness may only provide additional direct testimony in response to testimony elicited of another witness, and if that responsive testimony is likely to consume more than one hour, it shall also be in writing, filed and served at least two days before the witness is called to testify. (Cal. Code of Regs., tit. 10, §2655.8, subd. (a).) Rebuttal testimony is limited to response to the testimony of another party or witness and shall be in writing, filed and served at least two days before the rebuttal witness is called. (Cal. Code of Regs., tit. 10, §2655.9.)

unproven confiscation is irrelevant, inadmissible, will require undue consumption of time, and must be stricken.[5]

This is not a case of first impression. The California Supreme Court has previously addressed the issue of the constitutionality of rates imposed on insurance companies against challenges that the regulatory rates were confiscatory. In *20th Century Ins. Co.* v. *Garamendi*, *supra*, the Court held that the Insurance Commissioner has the power to adopt regulations to implement the provisions of Proposition 103 and to resolve claims that the rates set pursuant to the initiative are confiscatory (*Ibid.*, at p. 280). The Court upheld the rate regulations, including the ratemaking formula and the establishment of a certain rate of return, and rejected claims that the ratemaking formula was arbitrary and confiscatory. (*Ibid.*, at pp. 282, 297, 302.)

Although a brief citation to the Supreme Court's opinion should suffice, Allstate recently claimed "confusion" as to the required elements of its proof and as to its understanding of the *20th Century* decision. (See Allstate's Motion for Clarification, filed August 31, 2007, pp. 2-3.) However, in *20th Century*, the California Supreme Court provided clear and detailed guidance for determining what Allstate needs to prove and whether Allstate has made *prima facie* proof of a case in favor of its variance request:

> "The standard for determining whether a state price-control regulation is constitutional under the Due Process Clause is well established: 'Price control is "unconstitutional ... if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt...."'" (*Pennell* v. *San Jose* (1988) 485 U.S. 1, 11 [99 L.Ed.2d 1, 14, 108 S.Ct. 849].) A "legitimate and rational goal of price or rate regulation is the protection of consumer welfare." (*Id.* at p. 13 [99 L.Ed.2d at p. 15].)

Such regulation is presumptively constitutional under the due process

[5] Contrary to Allstate's protestations, this is not a summary judgment. It is more similar in its impact, although not identical in its nature, to the situation in a civil trial where the defendant may move for a judgment of nonsuit, following the plaintiff's evidence. (Code of Civ. Proc. §581c.)

clause. (See, *e.g.*, *Tenoco Oil Co.* v. *Dept. of Consumer Affairs* (1st Cir. 1989) 876 F.2d 1013, 1022, fn. 15.) "The burden of proving" otherwise "rests on the party asserting the violation...." (*Ibid.*) It "is not easily met. For the last half-century, courts have upheld challenged governmental acts unless no reasonably conceivable set of facts could establish a rational relationship between the regulation and the government's legitimate ends." (*Ibid*, italics in original.)....

The takings clause limits the power of the states to regulate, control, or fix prices that producers charge consumers for goods or services. (See, *e.g.*, *Duquesne Light Co.* v. *Barasch* (1989) 488 U.S. 299, 307-308 [102 L.Ed.2d 646, 656-657, 109 S.Ct. 609].)

"Rate-making is indeed but one species of price-fixing. [Citation.] The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid." (*Power Comm'n* v. *Hope Gas Co.*, *supra*, 320 U.S. at p. 601 [88 L.Ed. at p. 344].)" (footnote omitted)

The crucial question under the takings clause is whether the rate set is just and reasonable. (See, *e.g.*, *Duquesne Light Co.* v. *Barasch*, *supra*, 488 U.S. at pp. 307-308 [102 L.Ed.2d at pp. 656-657].) If it is not just and reasonable, it is confiscatory. (*Ibid.*) If it is confiscatory, it is invalid. (*Ibid.*) "[I]t is the result reached not the method employed which is controlling." (*Power Comm'n* v. *Hope Gas Co.*, *supra,* 320 U.S. at p. 602 [88 L.Ed. at p. 345]; see *Duquesne Light Co.* v. *Barasch*, *supra*, 488 U.S. at p. 310 [102 L.Ed.2d at pp. 658-659].) The method may of course be traditional, and may involve case-by-case ratemaking using data reflecting the condition and performance of the regulated firm as an individual entity. But it may also be novel (see *Duquesne Light Co.* v. *Barasch*, *supra*, 488 U.S. at p. 316 [102 L.Ed.2d at p. 662] [stating that the "designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors"]), and may implicate formulaic ratemaking (see *Permian Basin Area Rate Cases* (1968) 390 U.S. 747, 768-770 [20 L.Ed.2d 312, 336-338, 88 S.Ct. 1344]) using data reflecting the condition and performance of a group of regulated firms (see *id.* at pp. 766-790 [20 L.Ed.2d at pp. 335-349]; *Giles Lowery Stockyards* v. *Dept. of Agriculture* (5th Cir. 1977) 565 F.2d 321, 327 ["The 'just and reasonable' principle does not require 'that the cost of each company be ascertained and its rates fixed with respect to its own costs.' [Citation.] It is permissible for an agency to use average costs rather than the costs of individual" regulated firms.]). It is not subject to piecemeal examination: "The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The

Constitution is not designed to arbitrate these economic niceties." (*Duquesne Light Co.* v. *Barasch, supra,* 488 U.S. at p. 314 [102 L.Ed.2d at p. 661].) And, of course, courts are not equipped to carry out such a task. (See, *e.g.*, *Harris* v. *Capital Growth Investors XIV* (1991) 52 Cal.3d 1142, 1166 [278 Cal.Rptr. 614, 805 P.2d 873] [stating that "we are ill equipped to make" "microeconomic decisions"].) "[S]o long as rates as a whole afford [the regulated firm] just compensation for [its] over-all services to the public," they are not confiscatory. (*B. & O. R. Co.* v. *United States* (1953) 345 U.S. 146, 150 [97 L.Ed. 912, 916, 73 S.Ct. 592].) That a particular rate may not cover the cost of a particular good or service does not work confiscation in and of itself. (See *id.* at pp. 147-150 [97 L.Ed. at pp. 914-916].) In other words, confiscation is judged with an eye toward the regulated firm as an enterprise.

The answer to the question whether the rate set is just and reasonable depends on a balancing of the interests of the producers of the goods or services under regulation and the interests of the consumers of such goods or services....

The *Hope* court made plain that the consumer has a legitimate interest in freedom from exploitation. (See *Power Comm'n* v. *Hope Gas Co.*, supra, 320 U.S. at p. 610 [88 L.Ed. at p. 349] [recognizing that "exploitation" of consumers "at the hands of natural gas companies" was an "evil[]"]; see generally, *Power Comm'n* v. *Pipeline Co.* (1942) 315 U.S. 575, 606-608 [86 L.Ed. 1037, 1060-1061, 62 S.Ct. 736] (conc. opn. of Black, Douglas, and Murphy, JJ.).)

The Hope court also made plain that, for its part, the producer "has a legitimate concern with [its own] financial integrity .... From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. [Citation.] By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." (*Power Comm'n* v. *Hope Gas Co.*, *supra*, 320 U.S. at p. 603 [88 L.Ed. at p. 345].)

It must be emphasized that the foregoing describes an interest that the producer may pursue and not a right that it can demand. That interest is "only one of the variables in the constitutional calculus of reasonableness." (*Permian Basin Area Rate Cases*, *supra*, 390 U.S. at p. 769 [20 L.Ed.2d at p. 337].) "A regulated [firm] has no constitutional right to a profit...." (*Jersey Cent. Power & Light Co.* v. *F.E.R.C.*, *supra*, 810 F.2d at pp. 1180-1181; accord, *Power Comm'n* v. *Pipeline Co.*, *supra*, 315

> U.S. at p. 590 [86 L.Ed.2d at p. 1052] ["regulation does not insure that the business shall produce net revenues"]; *Power Comm'n* v. *Hope Gas Co.*, *supra*, 320 U.S. at p. 603 [86 L.Ed. at p. 345], quoting *Power Comm'n* v. *Pipeline Co.*, *supra*, 315 U.S. at p. 590 [86 L.Ed.2d at p. 1051].) Indeed, such a firm has no constitutional right even against a loss. (See Market Street R. Co. v. Comm'n (1945) 324 U.S. 548, 564 [89 L.Ed. 1171, 1183, 65 S.Ct. 770] [holding that a rate is not necessarily "confiscatory" even if it "compel[s]" a regulated firm "to operate at a loss"].) (footnote omitted)
>
> In balancing the relevant producer and consumer interests for a just and reasonable rate, one is concerned with a "broad zone of reasonableness" and not with any particular point therein. (Permian Basin Area Rate Cases, supra, 390 U.S. at p. 770 [20 L.Ed.2d at p. 338].) So long as the rate set is within that zone, "there can be no constitutional objection...." (*Ibid.*)

(*20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at p. 291-294.) Allstate has chosen to ignore these precepts.

An exercise of the Insurance Commissioner's expertise is presumed to be valid, and Allstate must take on a heavy burden to show that the regulatory rate is unjust and unreasonable in its consequences. (See *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at p. 767.) To prove confiscation, Allstate must demonstrate "severe financial hardship." (*20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at pp. 296, 324-325.) Further, proof of an "inability to operate successfully" is a "necessary—but not a sufficient—condition of confiscation."(*Ibid* at p. 296.)

Allstate did not present any evidence of severe financial hardship or inability to operate successfully in its initial filing of direct testimony or in its supplemental testimony, even after it was given an extraordinary opportunity to fill the void in its proof. Instead, Allstate has fixated on a few sentences from the middle of a paragraph in the middle of the decision in *Federal Power Comm'n* v. *Hope Gas Co.*, *supra*. Allstate relies on a mere fragment of that decision, as follows:

> [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

(*Ibid.*, at p. 603, cited in *20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at p. 293.)

However, this is weak reed for Allstate to lean on. It is *obiter dictum* and taken out of context, and Allstate's reading of the passage suffers from a grammatical error. *Obiter dictum*, such as the statement quoted by Allstate, is not a part of the court's ruling and does not establish a rule or doctrine of law. (See *Brannen* v. *Workers' Comp. Appeals Bd.* (1996) 46 Cal.App.4th 377, 384.) Taking a few sentences out of context may change their meaning dramatically. In this instance, the opening and closing sentences of the paragraph out of which Allstate pulls its fragment alter the meaning of the entire paragraph significantly:

> The rate-making process under the Act, *i.e.*, the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. Thus we stated in the *Natural Gas Pipeline Co.* case that "regulation does not insure that the business shall produce net revenues."... For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint.

(*Federal Power Comm'n* v. *Hope Gas Co.*, *supra*, 320 U.S. at p. 603.)

Finally, Allstate commits a grammatical error by claiming that its quoted fragment establishes a legal rule for confiscation when Justice Douglas states, "By that standard the return to the equity owner should be commensurate...." That statement does

not proclaim a legal standard; rather, it refers back to the investors' or company's point of view and the norm they would hope to see established.

With no legal authority for its position, Allstate consistently relies on its claim that the interests of its investors trump the competing interests of all other stakeholders, including consumers. Having adopted that meritless position, Allstate proceeds to substitute its own calculations in place of components of the regulatory formula (*e.g.*, FF3F should replace the regulatory formula's "rate of return" component [Armstrong Supp., 3:11-22; Haworth Supp., 2:20-3:2]; Allstate's own internally developed leverage factor model should replace the regulatory formula's leverage factor component [Armstrong Supp., 3:23-28; Haworth Supp., 6:13-6:24]; Allstate should use its own premium trend, instead of the one provided for in the regulatory formula [Armstrong Supp., 5:14-6:7]; the regulatory use of "surplus" and SAP should be replaced by "book value" or "market value" and GAAP [Haworth Supp. 3:3-6:12]; the question of "confiscation" should be determined line-by-line, rather than as an end-result test, applied to the enterprise as a whole, contrary to the regulations and judicial authority. [Haworth Supp., 7:1-14:15].)

Although such *ad hoc* modifications of the regulatory formula are prohibited by regulation and judicial decision (Cal. Code of Reg., tit. 10, §2646.4, subd. (e); *20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at p. 312.), Allstate proclaims that its modifications are sufficient to prove confiscation and that its own rate is the minimum non-confiscatory rate. This conclusion is a *non sequitur*, since Allstate ignores the necessity of first proving that the regulatory formula's rate is confiscatory.

Even if all the testimony relating to FF3F and Allstate's other idiosyncratic modifications of the regulatory formula were not stricken, Allstate still has not made a *prima facie* case for confiscation. For example, the rate imposed on Allstate should be sufficient to cover the "out-of-pocket costs" or "operating expenses" of a reasonably efficient firm and, arguably, some profit, although a regulated firm has no constitutional right to a profit. (*Permian Basin Area Rate Cases*, *supra* 390 U.S. at pp. 770-771; *20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at p. 294.) Whether the imposed rate in this case is confiscatory should be tested by evidence that the imposed rate is less than Allstate's explicit per policy out-of-pocket costs or operating expenses, according to the regulatory formula. Allstate should have provided evidence to quantify its regulatory out-of-pocket or operating expenses, per policy, but it did not do so.

In supplemental testimony, Mr. Armstrong testified that the unmodified regulatory rate would provide for revenue of approximately $826 per policy, and using Allstate's modified formula, Allstate should collect $936 per policy to cover all the costs it has unilaterally calculated, including its FF3F cost of capital. (2:7-3:14.) However, Allstate never presents evidence of its explicit regulatory out-of-pocket costs or operating expenses. Allstate conceals these regulatory costs by lumping them together in its own *ad hoc* calculation of costs, along with implicit costs, opportunity costs, and an extraordinary rate of return under the FF3F formula. Therefore, it cannot be determined in this proceeding whether the $826 in revenue, per policy, is greater than, less than, or equal to Allstate's regulatory explicit costs. Since this missing evidence was within the power of Allstate to produce, and Allstate failed to produce it, evidence relating to Allstate's self-

serving formulae is viewed with great distrust. (Evid. Code §412; *Westinghouse Credit Corp.* v. *Wolfer* (1970) 10 Cal.App.3d 63.)

The ALJ finds that Allstate has not made a *prima facie* showing of facts necessary to meet its burden of proof in support of its Variance Request No. 11. Therefore, all of the evidence adduced by Allstate relating to Variance Request No. 11 is irrelevant and shall be excluded. (Cal. Code of Regulations, tit. 10, §2654.1.) CDI and FTCR have renewed their motions to strike portions of testimony by Steven D. Armstrong, J. David. Cummins, and Michael J. Miller, filed with Allstate's initial round of direct written testimony. That testimony was conditionally admitted, subject to later striking if Allstate did not establish a *prima facie* case for confiscation. In view of the foregoing, all of the testimony conditionally admitted pursuant to the Order filed August 7, 2007, must be stricken.

ORDER

Accordingly, IT IS ORDERED that the motions by CDI and FTCR to strike supplemental testimony filed by Allstate, and their renewed motions to strike Allstate's conditionally admitted testimony, are granted as follows:

FTCR Motion to Strike Portions of Supplemental Testimony by Mr. Armstrong.

a) GRANT as to the term, "Nonconfiscatory Rate", wherever it appears in the testimony: (improper legal conclusion).

b) GRANT as to 2:14-21, 2:22-26 (impermissible relitigation).

c) GRANT as to 3:1-4 (impermissible relitigation).

d) GRANT as to 3:5-14 and Exhibit 93 (impermissible relitigation).

e) GRANT as to 3:16-23 (improper legal conclusion).

f) GRANT as to 4:1-6 (impermissible relitigation).

g) GRANT as to 4:7-8 (impermissible relitigation).

h) GRANT as to 4:11-20 (impermissible relitigation).

i) GRANT as to 4:20-28 (impermissible relitigation).

j) GRANT as to 5:12-6:7 (impermissible relitigation).

CDI Motion to Strike Supplemental Testimony by Mr. Armstrong.

a) GRANT as to 2:13 (impermissible relitigation).

b) GRANT as to 2:15 (impermissible relitigation).

c) GRANT as to 2:16 (impermissible relitigation).

d) GRANT as to 2:22 (impermissible relitigation).

e) GRANT as to 3:16 (impermissible relitigation and improper legal conclusion).

f) GRANT as to 4:11 (impermissible relitigation).

g) GRANT as to 4:22 (impermissible relitigation).

h) GRANT as to 5:6-7 (impermissible relitigation).

i) GRANT as to 5:9 (impermissible relitigation).

FTCR Motion to Strike Portions of Supplemental Testimony by Mr. Armstrong.

a) GRANT as to the term, "Nonconfiscatory Rate", wherever it appears in the testimony: (improper legal conclusion).

b) GRANT as to 2:3-15 (impermissible relitigation).

c) GRANT as to 2:20-23 (improper legal conclusion).

d) GRANT as to 2:24-3:2 (impermissible relitigation).

e) GRANT as to 3:3-4:13 (impermissible relitigation).

f) GRANT as to 3:16-4:10 (irrelevant).

g) GRANT as to 4:14-20 (impermissible relitigation).

h) GRANT as to 4:21-24 (irrelevant).

i) GRANT as to 4:25-5:3 (impermissible relitigation).

j) GRANT as to 5:4-15 (impermissible relitigation).

k) GRANT as to 5:14-22 (impermissible relitigation; irrelevant).

l) GRANT as to 5:23-6:24 (impermissible relitigation).

m) GRANT as to 7:1-14:1 (impermissible relitigation).

i) GRANT as to 9:12-19 (impermissible relitigation).

CDI Motion to Strike Entire Supplemental Testimony by Mr. Haworth.

a) GRANT (impermissible relitigation).

Renewed motions by CDI and FTCR to Strike Portions of Testimony Previously Admitted Conditionally.

Allstate has not made a *prima facie* showing in support of its Variance Request No. 11, and all evidence adduced by Allstate relating to its Variance Request No. 11 is irrelevant and shall be excluded. Therefore, the renewed motions by CDI and FTCR to strike portions of testimony by Steven D. Armstrong, J. David. Cummins, and Michael J. Miller, conditionally admitted by order dated August 7, 2007, are GRANTED.

Dated: September 19, 2007.

CHRISTOPHER R. INAMA
Administrative Law Judge
California Department of Insurance